Due Diligence

Things You Should 'DO' Before Leasing or Buying Commercial Real Estate

In real estate matters, "due diligence" is the process that a reasonable and prudent person uses to acquire knowledge of facts that, if known, would materially influence his or her decision to lease or purchase real property. This month's column focuses on some of the issues that tenants and buyers commonly overlook when evaluating commercial property.

READ THE MOUSE PRINT: The barely readable wording that appears at the end of many lease and purchase contracts, and at the bottom of nearly every real estate ad, includes statements similar to these: *"Retain appropriate consultants to review and investigate the condition of the premises and legal sufficiency of the contract," and "This information has been secured from sources we believe to be reliable, but we make no representation or warranties, expressed or implied, as to the accuracy of the information"*. These disclaimers urge the reader to conduct independent investigations in order to confirm every factor that could possibly affect the viability of leasing or buying the property.

CHOOSE YOUR ADVISORS WISELY: Your real estate advisor should coordinate the entire due diligence process, including: conducting the search for *every* suitable space and building, regardless of who lists them; negotiating economic terms and conditions; verifying the representations of listing agents and property owners; and interfacing with your attorney, accountant, architect, building inspector, contractor, lender and title company. To ensure they can render unbiased opinions, true real estate advisors do not accept property listings. They can be paid hourly, by a flat fee, through commissions, or a combination of these.

WHEN LEASING

NEGOTIATE DISCOUNTS AND INCENTIVES: Comparative data, or *comps*, on completed lease transactions is non-existent, making it difficult for tenants to gauge how much they should reasonably expect to pay for space. Depending on market conditions, and the landlord's urgency, well-informed tenants should be able to negotiate a reduction in the advertised rental rate, a period of free rent, and a tenant improvement allowance sufficient to make the space suitable for their needs.

CONFIRM THE SQUARE FOOTAGE: As the number of square feet in a space (plus any common area) generally determines the monthly rental amount, it's a good idea to field measure the suite to confirm the size of the space being leased - and be present when it is conducted.

INCLUDE THE SIZE IN THE CONTRACT: Be on the lookout for property owners and agents who negotiate on a price-per-square-foot basis but present a contract that fails to reference size, just a monthly rental amount. Without the square footage set forth in the agreement you are prevented from ever challenging the size of the space.

VERIFY THE AGE OF THE HVAC: Confirm the age and condition of the heating, ventilation and air conditioning equipment, its capacity, and whether any warranties exist. If the unit is nearing the end of its useful life, it would be wise to negotiate a reasonable warranty period as well as a limit on any out-of-pocket expenses for the replacement, repair and maintenance of this potentially costly item.

PROTECT YOUR USE(S) AND LOCATION: Make certain there is language in the contract that prohibits the landlord not only from leasing space to any other tenant that offers your product or service(s), but also from relocating you to a less desirable portion of the center.

BUSINESS CONDOS

QUESTION THE NOT-SO-OBVIOUS: When buying a newly-constructed business condominium, make certain you have a clear understanding of how the cost of (common) demising walls is handled, and whether the concrete *slab* is included in the purchase price. Most developers will pay for these costs…but only if pressed to do so.

INVESTMENT PROPERTY

PAY ONLY FOR TODAY'S VALUE: The purchase price of investment real estate should be based on the current condition of the property and the verifiable net operating income (NOI), not questionable assumptions about any so-called *upside potential*. If you decide to pay for tomorrow's anticipated revenue stream today, require the seller to guarantee the projected rents for at least 12 months.

FLUSH OUT INDUCEMENTS: Landlords contemplating the sale of their property routinely grant generous inducements to attract tenants willing to pay high rental rates. The purchase price of the property is then calculated based on the capitalized value of the artificially inflated rental schedule. As the value of free rent and other concessions are many times not disclosed in lease agreements or estoppel certificates, it's a good idea to interview every tenant to determine what type of incentives were granted to each, and if they plan on renewing their leases.

CLOSING THOUGHTS: Once the contract has been signed and money changes hands, it's too late for any "do-overs." While proper investigations can be time-consuming and may come with a price, they are generally preferable to relying on unsubstantiated claims, agents with undisclosed conflicts of interest, and possible misinformation. The wise tenant or buyer will question, verify and document everything…*it's the least you should do!* ■

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